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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Statutory Review of the System	)	
for Regulating Rates and Classes	)	Docket No. RM2017-3
for Market Dominant Products	)	

Comments of Connectiv, a division of the
Software & Information Industry Association

March 20, 2017

Connectiv is an association representing over 200 world-class business information companies who reach an audience of more than 100 million professionals. These companies drive more than $20 billion in annual revenues, and their collective industries represent a $400 billion global market. Together, Connectiv members represent thousands of print and online titles, with more than $20 billion in annual revenues. Formerly known as the American Business Media Association (ABM), Connective helps member companies of all sizes navigate the evolving content technology landscape. Connectiv members remain heavily invested in Periodicals, publishing hundreds of Periodical titles, and they mail millions of magazines, newsletters and brochures each year. These companies represent more than 10 percent of the periodicals class within the U.S. Postal Service. In addition, our members utilize first-class and standard mail extensively, and they collectively spend an estimated $300 million in postage each year.

Connectiv is a business division within the Software & Information Industry Association (SIIA), the principal trade association for the software and digital content industry. SIIA provides global services in government relations, business development, corporate education and intellectual property protection to the leading companies that are setting the pace for the digital age.

Introduction and Summary:

The Postal Service has accumulated a debt of approximately $81 billion, of which the vast majority, approx. $68 billion is due to the obligations, or "uncontrollable" expenses imposed by statute. Stated simply, the USPS has reached a financial breaking point largely because of the obligations imposed by Congress through the 2006 Postal Accountability and Enhancement Act (PAEA), rather than the outcome of the rate structure established by the legislation.

As the Postal Regulatory Commission ("Commission" or "PRC") conducts this Statutory Review of the System for Regulating Rates and Classes for Market Dominant Products (Review), it is imperative to not only take stock of the financial position of the U.S. Postal Service, but also to assess how the Postal Service arrived in this situation, and to practically assess the long-term outlook. The task before the Commission at this time is to evaluate the most challenging element of the current Postal Service business model: market dominant products. Market dominant products represent a declining-demand market, where the trend continued in FY 2016, resulting in revenue decline of 1.5 percent. This contrasts with competitive products, where the Postal Service has seen considerable growth—a 14 percent increase in volume and a $2.1 billion increase in revenue in FY 2016.

Given the reality of declining volume for market dominant products, the Commission is tasked with an overly-narrow endeavor where modifications to the rate system could not be expected to substantially improve the financial position of the Postal Service. That is, the statutorily-imposed "uncontrollable" costs, such as the requirement to pre-fund retires' health benefits and other benefits, such as workers' compensation, has created payment obligations that cannot reasonably be met through postal rate increases without exacerbating customer retention challenges. Therefore, it should be clear to the Commission, Congress and all stakeholders that Congress needs to act promptly to mitigate the overwhelming and unsustainable burdens created by PAEA.

That said, Connectiv strongly supports the ongoing oversight provided by the PRC; our members rely on the Commission to maintain a fair rate structure that recognizes the social and cultural value of publications we provide, and the cost that we are able to contribute to the system. Therefore, we welcome this Rate System Review as an opportunity to further evaluate inefficiencies and opportunities to improve cost savings. While we do not believe that the Commission was given significant authority to rescind the rate cap, we do believe that PAEA provided the ability for the Commission to amend the application and provide for alterations to accommodate changes to the USPS and postal customers over the last decade.

One of the most critical considerations before the Commission is the impact of greater rate increases on postal customers and the mailstream. As we have articulated over the last several years, small and medium-sized Periodicals publishers, including but not limited to Connectiv members, are not in a financial position to continue publishing Periodicals in the face of significant rate increases—such increases jeopardize their continuation as long-term customers of the Postal Service. We strongly believe the current Consumer Price Index (CPI) cap system provides effective external motivation for the Postal Service to control costs and appropriately scale itself to adapt to current and future trends in the postal market and resulting fluctuations in mail volume.

A snapshot of our average members reveals a steady decline in volume over the last decade. Companies that once relied on periodicals for approximately 90 percent of their revenues are now deriving less than 50 percent through Periodicals, where publications have been consolidated and cost considerations are paramount. This is due to a number of factors, including not only the continuously increasing cost of postal rates and consistently delayed delivery, but also declining advertising revenue and decreased customer demand have played a major role. The combination of these factors has, in many cases, led to a significant shift in focus to digital products and services.

However, despite these circumstances, our members still provide a substantial contribution to the Periodicals market, particularly for specialized business customers and niche consumer markets. Discussions with member companies reveal a commitment to retain substantial focus on Periodicals, as long as they remain economically viable to produce and deliver—it remains unknown, and subject only to speculation, whether there will be a greater demand from customers to move towards digital products and other services instead. But from the publishers' perspective, a substantial rate increases would be a major component that could precipitate further reduction in periodicals publishing, rather than allow it to stabilize around products with strong readership and revenue models.

As the Commission assesses the key considerations identified in the Rate and System Review, it is critical to not lose perspective that postal rates, even under the price cap, have risen more steadily than other contributing costs to Periodicals mailers. That is, at the time PAEA was enacted, overall costs of our members' Periodicals were comprised of relatively equal costs from paper, printing and postal expenses. Over the years, costs of resources and production have decreased dramatically, while postage costs now account for somewhere between 55 to 70 percent of total cost—this is up from 33 percent at the time PAEA was enacted. This is a result of increased production efficiencies and decreasing prices for materials and printing over the last decade, while at the same time juxtaposed with steady increases in postage on an annual basis over the same period.

Periodicals mailers have seen consistent annual rate increases over the ten-year period since PAEA, approx. 2.5 percent annually, although this is less than the rate increases of approx. 6 percent in the years leading up to the creation of the rate cap. In conducting this Rate Review, we urge the Commission to thoroughly assess why during a time of increasing efficiency within the U.S. workforce, the Postal Service has not been able to enjoy significantly increased efficiency and improved service standards, despite a steady revenue stream throughout most of this period. We strenuously disagree with the notion that higher rates on non-competitive products are the appropriate solution to the Postal Service's current financial challenges, nor are they an effective solution for the long run.

Below we provide additional input on several of the key objectives identified for this review process. Connectiv offers these comments as a trusted partner that is invested in the long-term success of the Postal Service. Thank you in advance for your consideration of our input.

Objective 1: To maximize incentives to reduce costs and increase efficiency.

Despite significant investment by the Postal Service to improve automation of flats and promote growth in mailer work-sharing, these goals simply have not been achieved. The inflation adjusted unit costs reported by the Postal Service for the Periodicals class increased by 69 percent from FY 1985-FY 2014. During this period, automation of the flats mail stream and the amount of work-sharing increased. At the same time, there has not been documentation of any trends that can be attributed to offsetting this progress and lead to increased costs. Indeed, this is a mysterious *increase* in costs for processing magazines and catalogues, rather than a reduction of these costs, as planned.

One of the key contributors to this increase in costs, which should be explored further in the Commission's review, is the performance and results of the Flats Sequencing System (FSS) machines, which the Postal Service invested heavily in. It was more than seven years ago that the

USPS began rolling out this system to improve the handling of flat mail, including publications, and the challenges have been recently increasing. According to the FY 2016 Annual Compliance Report (ACR), FSS throughputs declined 6 percent last year, and the proportion of FSS mail that was sorted on older equipment or manually rose from 40 to 43 percent. “Mail Pieces At-Risk” also rose 6 percent, affecting 1 of every 18 magazines, catalogs, and retail flyers.

We have maintained a long-standing commitment to focus on operational issues to improve the cost coverage of periodicals. To that end, we have worked diligently with the USPS since 2010 to identify and implement efficiencies which can improve both periodical cost coverage and service performance. Specifically, we have been active participants in the Mailers Technical Advisory Committee (MTAC), attending quarterly meetings and participating in additional efforts, such as the USPS and Industry Flats Strategy Group, and engaging our member companies to improve processing efficiencies.

In 2011, periodical mailers worked with the Postal Service and agreed to more relaxed critical entry times applying to service standards. These changes were expected to result in more efficient use of postal flats processing equipment and personnel. In 2015, those critical entry times were relaxed even more. Unfortunately, the result for the past three years has been a decline in Periodicals Service Performance. From fiscal year 2014 through the second quarter of 2016, overall performance declined from about 81 percent to 76.5 percent and end to end performance from 66 percent to 59 percent. Destination Entry service declined from about 86 to 82 percent. These results are not close to the established Postal Service goal for Periodicals of 92 percent.

The Network Rationalization Initiative, a reduction in the number of processing facilities, was supported by a large majority of the mailing industry, and it was implemented to take cost out of the system while maintaining service levels. The mailing industry has also worked with the Postal Service on other specific areas of concern including bundle breakage and more efficient mail makeup rules, including mail make-up rules for the FSS equipment. Results of these efforts has been mixed, as Periodicals delivery service has declined and cost coverage, after improving from 72 percent to 76 percent from 2013 to 2014, has receded to about 75.62 percent currently. This is an issue that has already been examined closely by the PRC as well as the Postal Service, but we are hopeful this review process can provide recommendations to guide the Postal Service to better take advantage of modernization and efficiencies to achieve greater cost coverage for periodicals.

As the Commission noted in its 2015 Annual Compliance Report, inefficient pricing signals may contribute to periodicals revenues not covering costs if the price does not signal mailers to prepare periodicals mailings efficiently. But the Commission went on to say that even though some work-sharing discounts exceeded avoided costs, this situation was consistent with ESCI values and thus consistent with 39 U.S.C. 3622(e). We do agree with and support the PRC that efforts toward improved efficiency by sending more efficient price signals should always be occurring. In fact, efforts to send better pricing signals have been, and still are, taking place between the Postal Service, the PRC and Periodicals mailers. These efforts should continue, and we are hopeful that they can result in improvements in cost coverage whatever that true number might be.

The objective, given the declining-demand nature of Market Dominant products, must be to continue to increase efficiency and control costs, rather than raising rates. While the rate cap has not been as effective at achieving this goal as we had hoped, we believe that it has provided for significant incentive for the Postal Service to increase efficiency and control costs. As we note above, significant rate increases on Periodicals, particularly among small publishers, are likely to be counter-productive. Unless rates can remain steady and predictable, and service performance can increase, the volume of specialized periodical mail produced by Connectiv members is likely to further decline, depriving the Postal Service of greater revenue over the long run.

Objective 2: To create predictability and stability in rates.

For the most part, the postal rate cap has been successful in providing predictability and stability in rates. However, the objective to create predictability and stability in rates is somewhat at odds with the objective to allow the postal service pricing flexibility. That is, the ability of the Postal Service to raise and lower the price of products within a class, provided that the class-weighted average rate increase does not exceed the cap, has led recently to significant rate cell increases and a lack of predictability for many mailers, particularly Connectiv members. While the average annual CPI increases have remained predictable across the entire class, and provided for a stable rate throughout most of the last decade, mailers of certain Periodicals have recently seen increases more than double that amount due to substantial increases within certain rate cells.

Most notably, in 2015, in addition to the annual CPI increase of approx. 2 percent in April, some of our members experienced 9 percent increases. This was due to greater than average increases in some rate cells, particularly for publications with low circulation, low advertising and low to medium weight.

The end result is dramatic cost variances among various Periodicals, and throughout the industry. These increases across various rate cells have had an outsized effect on small and medium-sized publishers, such as Connectiv members, who lack the resources and volume and/or density to take advantage of the lower cost rate cells which received the smaller increases. One example is the carrier route rate cell. High volume is needed to qualify for this, or special equipment is needed to combine publications into one mail stream to increase the volume. Most of our members have small volumes or are manufactured at printing facilities who do not have the special equipment to combine the publications into one mail stream. Not only do increase on these rate cells have a greater rate impact on Connectiv member companies, implementation of this flexible pricing poses a less predictable environment for these mailers. Connectiv member companies budget their mailing costs early in the year, based on expectations from the announced CPI increase. Fluctuations within the class is unknown to most mailers when they are budgeting, and significant variations can have an outsized effect on budgets.

Objective 3: To maintain high quality service standards established under Section 3691.

On-time service performance is imperative to our members, particularly for those who provide weekly publications where customers are expecting to receive them on a particular day. As noted above, we have worked consistently to achieve greater efficiency and cost coverage for Periodicals, but these efforts have not always been met with success. On the contrary, on time delivery is currently at 69 percent, well below the 92 percent standard set for the Postal Service. Unfortunately, evidence and data pertaining to ongoing processing difficulties due to FSS processing indicates that it is unlikely that the system will end up saving money, let alone recoup its $1.3 billion investment.[1]

Evidence also suggests that this is not likely to get better soon. According to the "FSS Scorecard" section of the agency's Annual Compliance Report, the already inefficient FSS machines ran even slower in FY 2016, posting a significant decline in Delivery Point Sequence and an increase in Mail Pieces-at-Risk from 5.34 percent to 5.67 percent.[2] These performance

[1] Tree, D. Eadward. Will Publishers Pay for the USPS's FSS Fiasco?; *Dead Tree Edition*. January 11, 2017
[2] United States Postal Service FY 2016 Annual Compliance Report. December 29, 2016.

declines come despite significant efforts by the Postal Service, such as "tiger teams," adjustments to machine operations and changes to mailing rules that were also focused on making FSS work better.

One of the key outcomes of this review should be to incentivize better performance and greater efficiency. Some Periodicals mailers are more affected by on-time-delivery than others. Of course, when it comes to service standards, the proposed solution from the Postal Service has been to increase rates. But there is no reason to expect that this would provide improved service. While it might seem tempting to consider rate increases directly associated with higher service, the lack of evidence in favor of sustained efficiency, raising rates and requiring customers to pay for the inadequacies of the Postal Service performance hardly seems like it could be expected to increase efficiency in either the short or long-term.

Objective 4: To allow the postal service pricing flexibility.

The current system has worked thus far in providing for significant pricing flexibility for the Postal Service—even though the Postal Service seeks virtually unlimited flexibility. While the Postal Service has lamented the lack of flexibility under the current system, it has proven more flexible, efficient pricing where the USPS has been able to increase rates annually, without having to demonstrate a need, as it did prior to the institution of the price cap. The process for implementing these rate increases is considerably less laborious as it was prior to the current system.

As noted above, there is considerable pricing flexibility around rate cells within various classes of mail. While pricing flexibility is a positive objective in many regards, at the end of the day, increasing USPS pricing flexibility can translate into detrimental impacts on mailers in the form of unequitable increases. This can occur with less predictability, as we saw recently with the exercise of a wide latitude for rate variance. Therefore, any efforts to enhance pricing flexibility should take into consideration the impact this has on mailers, particularly if the flexibility is not strategically applied to accommodate the goals of rate predictability and of long-term, sustainable cost-coverage objectives that have been fairly applied over the last decade. The rate cell variations in 2015 produced a result where rates were increased most on those who are least able to take advantage of discounts. For mailers, such as Connectiv members, and for the Postal Service seeking to increase cost coverage for certain Periodicals, this is an unsustainable model.

Objective 8: To establish and maintain a just and reasonable schedule for rates and classifications, however the objective under this paragraph shall not be construed to prohibit the Postal Service from making changes of unequal magnitude within, between or among classes of mail.

Critical to this objective are the definitions of "just" and "reasonable." We concur with the assessment offered in Order No. 3673 for the classification of rates and classifications as "just" if they not resulted in "excessive price increases," and the assessment of the schedule of rates and classifications as "reasonable" if these prices "do not threaten the Postal Service's financial integrity." Perhaps no other objective in this Rate System Review gets closer to the heart of assessing whether or not the price cap system has achieved its overarching goals. We are confident that the results of these two assessments will conclude that the current system has been just and reasonable, therefore achieving its goals as established by Congress. Although we remain disappointed with recent declines in on time delivery and processing efficiency metrics, we believe these both can be improved upon with proper focus and incentives, and that the current rate cap system is the best environment under which to continue incenting improvements from the Postal Service.

Objective 9: To allocate the total institutional costs of the Postal Service appropriately between market dominant and competitive products.

The postal market is experiencing fundamental changes, as it has been over much of the last decade. We have seen a patter where first class, periodicals, and other market dominant products are in decline, while parcel volumes are increasing steadily. These trends have been ongoing for several years, ironically both as the result of disruption by the internet. While the internet has given rise to automated—paperless—business processes and new digital information products that sometimes replace or reduce demand for periodicals, they have had the opposite effect on parcels. The rise in online shopping has, at the same time, has created a boom for parcel service. This new growth has attributed to significant revenue growth for the Postal Service, even while market dominant products have been declining.

Competitive Products collectively are the fastest growing segment of the Postal Service's market, and they comprise an increasing share of Postal Service revenue and volume. Therefore, these products should be expected to bear a much greater share of the Postal Service's institutional costs going forward. Towards the goal of maximizing the U.S. Postal Service's Profits from Competitive Products, we concur with the recommendation for the PRC to gradually increase the share of institutional costs that it requires the Postal Service's competitive product revenues to cover. In doing this, the Commission would be able to identify the share that maximizes the Postal Service's profits based on readily observable data.[3] While we hope that this could be an outcome of this review process, we also support the notion that the Postal Service's Board of Governors could independently implement such a gradual price increase as an exercise of managerial discretion, or that Congress will direct the Postal Service to maximize profits from its competitive products as part of postal reform legislation.[4]

While these markets both lack predictability over the next decade—and farther into the future—it is reasonable to expect that as parcel volume increases and market dominant volume either further declines or fails to rebound, and therefore the fixed cost attributed to parcels should also increase.

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[3] Sidak, J. Gregory. Maximizing the U.S. Postal Service's Profits from Competitive Products; *Journal of Competition Law & Economics*. September 9, 2015.
[4] Ibid.